United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

77-7125 77-7126

United States Court of Appeals
For the Second Circuit

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P/S

DOROTHY L. COLE, LOIS H. ZISOOK, HARRY W. VOEGE, and ANNA MAY TUNMORE, as Trustees, SAMUEL GREENFIELD FUND, INC. and HAROLD STILLER and MILDRED STILLER, as joint tenants,

Plaintiffs,

DOROTHY L. COLE, HARRY W. VOEGE, and ANNA MAY TUNMORE, as Trustees, and HAROLD STILLER and MILDRED STILLER, as joint tenants,

Plaintiffs-Appellants,

v.

SCHENLEY INDUSTRIES, INC., GLEN ALDEN CORPORATION, RAPID-AMERICAN CORPORATION, ISIDORE A. BECKER, BERNARD GOLDBERG, PAUL A. JOHNSTON, DAVID A. CHERNOW, WALTER O. HEINZE, HOWARD FELDMAN, MILO B. HOPKINS, RUSSELL G. SMITH, ALBERT N. GREENFIELD, MESHULAM RIKLIS, GLEN ALDEN SUBSIDIARY, INC., P.J. CLIFFORD, W.P. JOHNSON, S. KITTAY, M.L. MENDELL, L.C. LANE, G.H. PERKINS and B. DENMARK,

Defendants-Appellees.

UNITED STATES COURT OF APPEALS
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SECOND CIRCUIT

ON APPEAL FROM A JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF OF PLAINTIFF-APPELLANT DOROTHY L. COLE

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

DOROTHY L. COLE, HARRY W. VOEGE and
ANNA MAY TUNMORE, as Trustees, and
HAROLD STILLER and MILDRED STILLER,
as joint tenants,

Plaintiffs-Appellants

-against-

SCHENLEY INDUSTRIES, INC., GLEN ALDEN CORPORATION, RAPID—AMERICAN CORPORATION, ISIDORE A. BECKER, BERNARD GOLDBERG, PAUL A. JOHNSTON, DAVID A. CHERNOW, WALTER O. HEINZE, HOWARD FELDMAN, MILO B. HOPKINS, RUSSELL G. SMITH, ALBERT N. GREENFIELD, MESHULAM RIKLIS, GLEN ALDEN SUBSIDIARY, INC., P.J. CLIFFORD, W.P. JOHNSON, S. KITTAY, M.L. MENDELL, L.C. LAND, G.H. PERKINS and B. DENMARK,

Defendants-Appellees

REPLY BRIEF OF PLAINTIFF—APPELLANT DOROTHY L. COLE

I. *The Proxy Statement's Failure to Reveal the Extent of Schenley's Surplus Cash.*

Defendants state at pages 34-35 of their brief ("Br.") that any deficiency in the Proxy Statement with respect to revelation of the surplus character of Schenley's cash could be overcome because "any shareholder could compare Schenley's balance sheet with public financials of other companies." And defendants concede that the Proxy Statement by itself is inadequate when they suggest that in order to learn what was in Schenley's relevant balance sheets, the shareholder would have to refer to information to be found *not* in the Proxy Statement, but in Schenley's previously published financial statements and other documents issued by Schenley and Glen Alden (Br. p. 11 and 15).*

*Indeed even the so-called "basic facts", which defendants claim the Proxy Statement discloses adequately, are not visible, as defendants acknowledged, except by going to sources outside the Proxy Statement. As plaintiff Cole states at page 15 of her brief ("Cole Br.") Schenley generated at least $215 million of cash between May 1, 1968 and May 31, 1971. Defendants concede that "A review of Schenley's publicly disclosed balance sheets shows that the alleged $215 million improvement in liquidity resulted from transactions that were fully disclosed to shareholders..." (Br. p. 15) The balance sheets to which defendants refer (Ex. 7-9, A1340) are not in the Proxy Statement. Some were included in a tender offer prospectus dated August 8, 1968 (Ex. 3, A1172) and in a proxy statement dated November 19, 1969 (Ex. 2, A1073). Page F-27 (A1042) hardly reveals any significant portion of the $215 million improvement, as defendants faintly suggest (Br. p. 11).

Defendants' obligation to disclose to minority stockholders in this case is not satisfied by inviting them to engage in their own research for information in public manuals and previously published financial statements. The adequacy of disclosure must be tested by what is contained in the "four corners" of the proxy statement *Puma v. Marriott*, 363 F. Supp. 750, 758 (D.C.Del. 1973); aff'd. 506 F.2d 1399 (Cir., 1974). Certainly extraneous material which was not distributed to the recipients of the Proxy Statement is not to be considered.

(b)

To support their contention that the Proxy Statement accurately and adequately set forth the facts about the amount of surplus cash, defendants rely mainly on Page 3 thereof which in relevant part asserted:

Certain Significant Aspects of the Proposed Reorganization:

1. Holders of Schenley Common Stock and $1.40 Preferred Stock have the right, under Delaware law, to demand payment of the appraised value of their stock provided they comply with the requirements of the Delaware law. See "Right of Appraisal".

2. The proposed reorganization will result in Glen Alden becoming the owner of all of the equity securities of Schenley (except the Schenley Preference Stock) and will permit Glen Alden to transfer funds from Schenley to itself, including a substantial portion of the proceeds of the recent sale of Schenley's subsidiary, The Buckingham Corporation ("Buckingham"), subject only to applicable restrictions in Schenley's various loan agreements. See "History and Business of Schenley—Recent Developments". Subject to the consummation of the proposed reorganization and the said loan agreement restrictions, substantial funds of Schenley will be transferred to Glen Alden. These funds will initially be added to Glen Alden's general working capital and will provide a source for payment of current maturities of Glen Alden's long-term debt. The following table reflects certain comparative information as at December 31, 1970 with respect to (i) Glen Alden and its consolidated subsidiaries other than Schenley and its subsidiaries, (ii) Schenley on an historical basis, and (iii) Schenley, pro forma, after giving effect to the recent sale of Buckingham:

	(In Millions)		
	Glen Alden	Schenley	Schenley Pro Forma(1)
Cash, Certificates of Deposit and Marketable Securities	$39	$72	$162
Net Quick Assets(2)	(65)	20	111
Current Maturities of Long-Term Debt	77(3)	2	—

(1) For information with respect to the recent sale of Buckingham, see "History and Business of Schenley—Recent Developments" elsewhere herein.

(2) Consists of cash, certificates of deposit, marketable securities and receivables, less total current liabilities.

(3) Includes approximately $53,000,000 of notes payable to banks which had an original maturity date of June 30, 1970 which date was extended to February 1, 1971. On February 1, 1971, $30,000,000 of these notes were paid by Glen Alden, in part through application of the proceeds of the sale of its subsidiary RKO-Stanley Warner Theatres, Inc., and the maturity date of the remaining notes was further extended to August 1, 1971. "

The decisive question here is did paragraph "2" tell the reader of the Proxy Statement how much surplus cash Schenley had and how much would be transferred to Glen Alden for its own use?

We showed in our main brief (Cole Br. p. 34) that the reasonable inference from this paragraph was that not more than $47 million was surplus to be used by Glen Alden for its own purposes. We call to the court's attention that paragraph "2" above indicates that Schenley was forbidden from transferring cash to Glen Alden by the "applicable restrictions in Schenley's various loan agreements." Those agreements, the Proxy Statement discloses (See Note 5, at page F-30 A1045), precluded Schenley from using more than $79,909,736 to acquire its capital stock. In short, the propriety of inferring a maximum of $47 million as the "substantial portion" of cash to be transferred to Glen Alden was supported by the existence of the explicit limits in the very loan agreements to which paragraph "2" referred.

Yet defendants contend (Br. pp.26-27), just as they contended below (see Cole Br. pp. 50-51), that paragraph "2" was sufficient, because it told the stockholders that anywhere from $47 million to $120 million was to be transferred to Glen Alden free from any need Schenley might have for such funds. As we pointed out (Cole Br. pp. 50-51), this range of possible disclosure simply transcends the limits of permissible ambiguity.

(c)

Defendants offer as evidence of the adequacy of the proxy statement (to inform the stockholders of the extent of surplus cash) the fact that plaintiffs' lawyers and experts were able to assert in complaints and in court that surplus cash was $115 million or $200 million (Br. p.27). That evidence is as flawed as is the logic with which it is offered. All of the lawyers and experts to whom defendants refer researched a great deal more than simply the Proxy Statement, and their estimates of the amount of surplus cash was predicated on information defendants had failed to disclose in the Proxy Statement. More important, the logic of defendants' argument is the logic of Catch-22— it proves too much. Any time lawyers or experts discover omissions in a statement, the fact that they were able to make that discovery proves that the omission was not culpable!! By that logic the filing of the complaint denies the cause of action.

II. *The Proxy Statement's Failure to Reveal the Amendment to Schenley's Loan Agreements.*

A note to the Schenley audited balance sheet that appeared in the Proxy Statement states that "payments for dividends and the acquisition of Schenley capital stock are restricted to the sum of $79,909,736 at December 21, 1970" (Ex. 1, page F-30, Note 5, A1045). The undisputed testimony of the chief financial officer of Schenley, Mr. Chernow, was that it was necessary to obtain the consent of its long-term lenders in order to distribute $98 million in connection with the merger (A 428) and that a director of Schenley had visited with the Prudential Life Insurance Company early in April of 1971, or perhaps the end of March, to request its consent to increase from $80 million to $115 million the amount that could be used by Schenley for acquiring the capital stock from the minority stockholders in the merger (A 430-431).

By letter agreement dated June 7, 1971, Schenley received permission to pay out in the merger an "aggregate amount of... cash and the cash cost to [Schenley]" of purchasing the 7½ Debentures from Glen Alden in an amount "that shall not exceed $115 million" (A1403). Plaintiffs contended to the court below (A 429-30, 435, 437, 442-43), as it does here (Cole Br. p. 15), that this amendment to the Schenley loan agreement which permitted Schenley to pay out $115 million in connection with the merger was a material fact which the Proxy Statement was required to disclose. Such disclosure quantified the deceptive, misleading statements in paragraph "2" with respect to the amount of the "applicable loan agreements" and to the amount of the "substantial funds" to be transferred to Glen Alden. Without this amendment to the loan agreement, the merger could not be consummated. The Schenley directors, early in April 1971, had taken the steps which had "established the basis for the consent that would be obtained" (A 430-431). The $115 million dollar figure requested by management and consented to by the bankers was a clear expression that such an amount of cash in the judgment of Schenley's management and Schenley's bankers could be withdrawn without adversely affecting the operations or credit of Schenley.

The disclosure of the $115 million figure would have alerted the stockholders to the possibility that in view of that opinion of Schenley's lenders the minority's share could be worth $17 million more (or about $5.30 per share) than management was prepared to pay out in the merger.

Nevertheless, defendants say* the relevance of this amendment to the proxy material "is simply non-existent." In view of the fact that the merger described in the Proxy Statement could not be executed without an amendment to the loan agreement, this position flies in the face of S.E.C. Rule 14a-9, (17 C.F.R. Subs. 240. 14a-9) sub-paragraph (a) of which requires an issuer *"to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading."* (emphasis added)

This Court voiced strong disapproval of such failure to correct a proxy statement in *Gamble Skogmo, supra*, where Judge Friendly said:

> **"While in view of our holding that the Proxy Statement was misleading on other grounds, we likewise find it unnecessary to rule on this argument, we cannot suppose that management can lawfully sit by and allow shareholders to approve corporate action on the basis of a proxy statement without disclosing facts arising since its dissemination of these are so significant as to make it materially misleading, and we have no doubt that Rule 14a-9 is broad enough to impose liability for non-disclosure in this situation. See General Time Corp. v. Talley Industries, Inc., 403 F.2d 159, 163 (2 Cir. 1968), cert. denied, 393 U.S. 1026, 89 S.Ct. 631, 21 L.Ed. 2d 570 (1969). (478 F2 at 1297 note 15)**

In *Gould, supra*, the District Court said at 351 F. Supp. 868:

> **Rule 14a-9 specifically requires that solicitation material which has become false or misleading must be corrected by subsequent materials. Thus, assuming that**

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* (Br. p. 30)

> **the McLean proxy materials were accurate when initially approved, the proxy materials should have been amended to reflect subsequent occurrences or changes which rendered the initial disclosure false or misleading. Insofar as they knew or ought to have known that facts originally disclosed subsequently became inaccurate, the directors were under a continuing obligation to make certain that the proxy materials were amended and remained complete and accurate. (footnote omitted)**

As shown above, defendants knew well before the mailing of the Proxy Statement that the loan agreements had to be amended to permit $98 million to be removed from Schenley's treasury. Under those circumstances, defendants were obliged to amend the proxy material in order to make the proxy statement "not false or misleading" (Rule 14a-9).

III. *The Proxy Statement's Failure to Reveal Glen Alden's Opinion of the Value of Schenley.*

When Glen Alden's management valued the Schenley common stock at $29.00 per share, they were of the opinion that Glen Alden's investment in the Schenley common stock had not diminished in value since acquisition in 1968 at a cost of $58.80 per share. That opinion is set forth in a footnote to Glen Alden's December 31, 1970 financial statement prepared by management and approved by its auditors. Footnote D, page F-13 of the Proxy Statement (A1028); UF 2 and 37 (A110 and 110.13); A591, 592, 596-7). Defendants while not disputing the content of the footnote, contend that it had no weight or meaning as a "valuation" of the Schenley shares and therefore it was proper to bury it on the 79th page of the Proxy Statement (Br. 35, 36) rather than refer to it at page 4 at Subs. 5 where the cost of those shares was stated (A. 953).

But, surely, if Glen Alden was of the opinion that its investment in Schenley had diminished in value from $58.80 per share to $29.00 per share, it was obliged to so state (*Chris-Craft Industries, supra,* CCH. Fed. Sec. L. Rep., 1972-1973 Transfer Binder at p. 93, 351) as well as to amortize that diminution in value (*Fiflis and Kripke, Accounting For Business Lawyers,* 189, 438) and in the absence of such amoritization its financial statement would have contained a serious error which no accounting firm could certify consistently with generally accepted accounting principles. In view of the certification and the verification actually made by Glen Alden's accountants, the statement must reflect the continued belief of Glen Alden in the $58.80 carrying value of its investment in Schenley stock— or at least the belief that there was no material diminution of that value. We need hardly add that such a belief as to the value of Glen Alden's investment in Schenley shares was incompatible with a belief that $29.00 per share represented the value of Schenley's stock, or that in any event the disparity ought to have been called to the attention of a reasonable investor faced with a choice between seeking appraisal and accepting the merger.

IV. *The Inadequacy of the Proxy Statement's "Warnings."*

As we pointed out in our main brief (Cole Br. p. 28), defendants are not entitled to the credit they seek in their argument for warning stockholders to be careful how they grope around in the dark, because it was defendants' Proxy Statement that kept the stockholders in

the dark. Defendants' brief nevertheless seeks comfort from the proxy statement's "warnings" with respect to (a) the pending litigation seeking to challenge the fairness of the merger and (b) stockholders' appraisal rights (Br. p. 9).

(a)

Defendants say that "one of the most significant portions of the Proxy Statement is the description of the litigations with respect to the merger" (Br. p. 9). Those descriptions are at pages 8 through 11 of the Proxy Statement (A 957-960). There is nothing in those descriptions that informs a reader as to the amount or existence of surplus of excess cash or that Schenley was to buy the Glen Alden 7½% Debentures that would be distributed to the minority or as to the value Glen Alden attributes to its Schenley shares. Defendants do not point to any language in that section that would rectify the disclosure deficiencies in the Proxy Statement that are in issue here.

All the suits are described as being based on the excessively inadequate price that was being offered for the Schenley minority shares. Defendants say that from those descriptions "there could be no doubt in the mind of a shareholder that a group of shareholders was asserting that a share of Schenley was worth in excess of $50.00 and accordingly each should consider the desirability of exercising his or her appraisal rights under Delaware law" (Br. p.9). Having been told of all these suits that challenged the merger, the Schenley minority stockholders on whose behalf the suits were brought, would have found comfort in their existence. They could look to these suits to protect their interest and to avoid the need for them to resort to the complicated and expensive appraisal procedures described at pages 6 and 7 of the proxy statement (A 955-956).

Defendants concede that "Prior to and during the trial defendants asserted that the exclusive remedy for a claim of unfairness under Delaware law was a statutory appraisal proceeding," and cite a number of cases that were decided well before the date of the Proxy Statement (Br. p. 45). Defendants took that position before Judge Lasker in the *Voege* action and in the *Greene* action in Delaware. But the readers of the Proxy Statement were not told that it was Schenley's position that appraisal was the exclusive remedy for litigating the fairness of the merger terms. Indeed these descriptions of the numerous suits had the effect of lulling the minority stockholders into not seeking appraisal.

As pointed out in plaintiff's brief, defendants persuaded Judge Owen to dismiss the common law claims in *Cole* and to exclude any evidence dealing with the unfairness of the merger terms on the ground that a Delaware appraisal proceeding was the exclusive remedy (Cole. Br. pp. 55-60).

(b)

A reading of the Proxy Statement's discussion of appraisal rights (A 955-956) teaches only that such rights are expensive to enjoy and complicated to vindicate. Nothing in the entire proxy statement suggests that it might be worth the stockholders' while to incur the risks and costs entailed in pursuing those rights. On the contrary, as the main arguments in our briefs show, the Proxy Statement's failure to allude to or hint that the value of the Schenley shares exceeded the merger price would make it worthwhile for the outside stockholders to pursue those appraisal rights.

Prayer for Relief

The holders of approximately 200,000 Common and $1.40 Preferred shares were parties to the Delaware appraisal proceeding in *Gibbons v. Schenley Industries, Inc.*, 339 A.2d 460 (Del. Ch. 1975), in which the Chancellor found the fair value of the Schenley common to be $33.86 per share and the $1.40 Preferrerd to be $30.47, or 10% less than the common. Defendants say that approximately 1,000,000 shares were originally submitted for appraisal in *Gibbons*. (Br. p. 38) The undisputed fact (U.F. 13, A 110. 5-6) that was admitted in evidence (A 863) is that 910,000 shares objected to the merger of which 114,988 shares of common stock and 572,966 shares of $1.40 Preferred withdrew or were dismissed from the appraisal proceeding leaving a balance of approximately 200,000 shares. According to an order of the Delaware Chancery dated May 3, 1972, Dade and Company the record holder of 79,600 $1.40 Preferred shares (owned by Louis Rosenstiel) and Milton A. Nauheim, a former director of Schenley, the owner of 15,000 common shares, were among those who prosecuted the appraisal proceeding.

It is well established that one of the injurious consequences of a misleading proxy statement is that it "might cause a minority stockholder to lose by inaction or action the right to demand payment for shares and appraisal thereof." *Rosenblatt v. Northwest Airlines, Inc.*, 435 F.2d 1121, 1124 (2d Cir. 1970); *Gerstle, supra,* 487 F.2d at 1303; *Swanson v. American Consumers Industries, Inc.*, 475 F.2d 1326, 1332 (7 Cir. 1969); *Swanson v. American Consumer Industries, Inc.*, 475 F.2d, 516, 521 (7 Cir. 1973).

The holders of over 3,000,000 shares did not seek appraisal to begin with or withdrew or were dismissed from the appraisal proceeding. In face of the result in *Gibbons* and the failure of the Proxy Statement to reveal the facts relating to the higher value of the Schenley shares, the decision of the court below cannot possibly be explained or justified to the average investor or to the holder of 3,000,000 or more Schenley shares who were deprived of any recovery.

Should the Court determine that the disclosure defects in the Proxy Statement were material, then it would have ample precedent and a substantial basis for finding that the loss of appraisal rights was an injurious consequence of the defective disclosure. Here, the actual award in *Gibbons*— $33.86 for the Schenley Common and $30.47 for the $1.40 Preferred shares against the $29.00 and the $26.10 value respectively that was given in the merger to the minority shares (U.F.6. A110.2)— provides clear evidence of actual injury and "competent proof" of the amount of the damage that was caused by the loss of appraisal rights. *Pierre J. Landlois & Co. Inc. v. M D S - Atron, Inc.* 543 F.2d 421, 424, (2 Cir. 1976); *Mills v. Electric Auto Lite* 396 U.S. 375 (1970); *J.I. Case & Co. v. Borak* 377 U.S. 426 (1964); *Gamble-Skogmo, supra,* 478 F2 at 1303-08. (2 Cir. 1973).

Gibbons was very much a part of the record in this case. It formed the main ground for the trial court's dismissal of the common law claims and the court's refusal to hear evidence of the unfairness of the merger terms (Cole. Br. 55-61). Cf. *P.J. Landlois & Co.*, supra, 543 F.2d at 424-425).

Should the case be reversed and remanded for the determination of damages, as plaintiff requests, then it is respectfully submitted that this Court should instruct the court below that the minimum amount of damages to which the plaintiff class is entitled is the amount awarded with interest in *Gibbons*. Courts of appeal are authorized to "... affirm, modify... or reverse any judgment... brought before it for review... and direct the entry of such appropriate judgment... as may be just under the circumstances" (28 U.S.C. subsection 2106 1970). The precedents of this Court amply affirm such an exercise of power. *Chris - Craft Industries, Inc. v. Piper Aircraft Corp.* 516 F.2d 172, 186-187 (1975) and cases there cited; rev'd on other grounds 45 U.S.L.W. 4182 (February 23, 1977).

Respectfully Submitted

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